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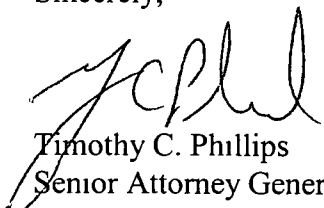
Honorable Pat Miller
Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

**RE: UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY
CORPORATION, INCENTIVE PLAN ACCOUNT AUDIT
Docket 01-000704**

Dear Chairman Miller:

Enclosed is an original and thirteen copies of the Direct Testimony of Daniel W. McCormac of the Consumer Advocate and Protection Division of the Office of the Attorney General. Kindly file the attached in this docket. Due to unforeseen circumstances, Mr. McCormac was unable to submit an affidavit certifying his Direct Testimony as his own. He will do so at a later date. By copy of this letter, we are serving all parties of record. If you have any questions, please feel free to contact me. Thank you.

Sincerely,


Timothy C. Phillips
Senior Attorney General
(615) 741-8700

Enclosures

cc: All Parties of Record

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CERTIFICATE OF SERVICE


I hereby certify that on July 30, 2004, a true and exact copy of the foregoing document has been sent to the following via method indicated below:

Via First class U.S. mail and facsimile

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Timothy C. Phillips
Assistant Attorney General

Before the

TENNESSEE REGULATORY AUTHORITY

**IN RE: UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY
CORPORATION COMPANY, INCENTIVE PLAN ACCOUNT (IPA) AUDIT**

DOCKET NO. 01-00704

**DIRECT TESTIMONY
OF
DANIEL W. McCORMAC**

July 30, 2004

BEFORE THE TENNESSEE REGULATORY AUTHORITY

AT NASHVILLE, TENNESSEE

**IN RE: UNITED CITIES GAS COMPANY, a Division of ATMOS ENERGY
CORPORATION COMPANY, INCENTIVE PLAN ACCOUNT (IPA) AUDIT**

DOCKET NO. 01-00704

AFFIDAVIT

I, Daniel W. McCormac, Coordinator of Analysts for the Consumer Advocate Division of the Attorney General's Office, hereby certify that the attached Direct Testimony represents my opinion in the above-referenced case and the opinion of the Consumer Advocate Division.

DANIEL W. McCORMAC

Sworn to and subscribed before me
this ____ day of _____, 2004.

NOTARY PUBLIC

My commission expires: _____

1 **Q. Would you state your name for the record, please?**

2 A. My name is Daniel W. McCormac.

3

4 **Q. By whom are you employed, Mr. McCormac, and what is your position?**

5 A. I am employed by the Attorney General's Office as Coordinator of Analysts
6 for the Consumer Advocate & Protection Division.

7

8 **Q. What is your educational background and what degrees and licenses
9 do you hold?**

10 A. I have a Bachelor of Science Degree in Accounting from David Lipscomb
11 College and I am a licensed Certified Public Accountant in the State of
12 Tennessee.

13

14 **Q. What is your experience in the field of ratemaking and regulatory
15 accounting?**

16 A. I have 28 years of experience in the field of utility ratemaking and regulatory
17 accounting including more than two years with the Certified Public
18 Accounting firm of Wilson, Work, Fossett & Greer as the supervisor in the
19 utility consulting segment. I served sixteen years with the Tennessee Public
20 Service Commission, including one year as Technical Assistant to the
21 Commissioners. I served two years as Chief of Energy and Water at the
22 Tennessee Regulatory Authority ("TRA") and eight years with the Office of
23 the Attorney General. While employed by the Commission and the Attorney
24 General's Office, I supervised the preparation of many utility rate cases and
25 earnings reviews. As part of these investigations, we developed financial
26 exhibits to present to the Commission or TRA. These investigations supplied

1 evidence to the TRA to enable it to set just and reasonable rates for utility
2 services. In addition, I participated in various special studies and provided
3 technical assistance in other cases in which I did not testify.

4
5 As the Technical Assistant to the Commissioners I observed hearings and
6 analyzed the issues in each case from an independent technical perspective.
7 I responded to the Commissioners' requests for expert assistance in
8 evaluating and interpreting the financial evidence in the record. I also
9 provided and checked calculations based on that evidence. In each position,
10 my responsibilities have included making decisions on whether the
11 information provided was adequate and suitable for deciding the questions
12 presented.

13
14 My duties with the Consumer Advocate and Protection Division ("CAPD") are
15 similar, but also include the review of various tariffs filed before the TRA. I
16 assist in the decision making process as to whether the terms and conditions
17 of the numerous filings are just and reasonable or whether additional
18 evidence is needed to support the filings. When significant consumer
19 interests appear to be in jeopardy, we investigate further and provide expert
20 testimony before the TRA when needed.

21
22 **Q. What expertise do you have related to the natural gas industry?**

23 **A.** Since 1976 I have been involved in auditing gas companies, reviewing
24 testimony, tariffs and exhibits, negotiating rates, and preparing testimony and
25 exhibits relating to various revenue, expense, and rate base issues of all
26 major Tennessee gas distribution companies. I have prepared testimony in

1 every major case involving a gas utility since my employment with the
2 Attorney General's office in 1994.

3
4 **Q. Would you please summarize the scope of the review that will be**
5 **addressed by your testimony in this docket?**

6 A. Yes. I examined the filings in Docket 01-00704 (consolidated Dockets 01-
7 00704 and 02-00850) dealing with:

- 8 1) Atmos Energy Corporation's ("AE") failure to follow the guidelines in
9 the existing Performance-Based Ratemaking Mechanism ("PBRM")
10 and
- 11 2) AE's request to expand the PBRM to make it more profitable for
12 Atmos.

13
14 **Q. What are the major areas of disagreement?**

15 A. 1. AE violated the existing PBRM incentive plan by filing reported
16 "savings" that are not covered by the existing incentive plan.

17
18 2. AE violated the existing PBRM incentive plan by reporting "savings"
19 that are not proven to exist when looking at all aspects of the
20 transactions.

21
22 3. AE's proposed changes to the PBRM make no attempt to provide a
23 reasonable balancing of the risks and rewards of management
24 operating practices.

25
26 4. There is no evidence to indicate that AE's proposed changes to the

1 PBRM will alter future behavior in a way that will reduce the total
2 delivered cost of gas.

3
4 5. AE proposes to add a new category of bonuses to the PBRM for
5 "savings" without having an accurate measure of savings.

6
7 6. Contrary to AE's proposal, changes to the PBRM formula (if any) can
8 not become effective before they are approved by the TRA.

9
10 **Q. What were the conclusions from your analysis of AE's proposed**
11 **interpretation of the existing PBRM plan?**

12 A. I conclude that AE's interpretation of the existing plan are not supported by
13 the facts in the record and that the TRA staff's findings in the audit report are
14 correct. AE's attempt to include transportation "savings" is a deviation from
15 the terms of the PBRM.

16
17 **Q. Does Atmos' proposed "TIF" formula provide a reasonable balancing**
18 **of the risks and rewards of management operating practices?**

19 A. No. There is no risk associated with a contract revision to reduce
20 transportation costs, therefore, Atmos should not receive a windfall profit for
21 doing so. Atmos admits that its proposed "standard of performance" is
22 based on the "maximum FERC rate." Since the proposed "standard" is the
23 same as the "maximum," there is **no risk** of transportation costs exceeding
24 the "standard" price. There is **no risk** that Atmos would have to share in a
25 "loss." By Atmos' definition, there can only be rewards for Atmos and higher
26 expenses for ratepayers being forced to pay the rewards. This is totally

1 contrary to the intent of the PBRM or any incentive base ratemaking
2 program.

3
4 **Q. Does the proposed incentive or reward change future costs and**
5 **produce savings?**

6 A. There is no evidence to indicate that AE's proposed changes to the PBRM
7 will alter future behavior in a way that will reduce the total delivered cost of
8 gas. AE is seeking windfall profits. Giving AE unearned windfall profits will
9 only increase costs to consumers

10
11 **Q. Are the proposed changes consistent with the TRA's findings in Docket**
12 **03-00209?**

13 A. No. Even if the "savings" were real, the proposal to move some of the
14 "savings" from the ratepayers to the company contradicts a recent change
15 in ratemaking policy established on February 9, 2004 in the Uncollectible
16 Accounts expense Docket 03-00209. The TRA adopted Atmos' arguments
17 and modified the refund formula in the PGA rule (1220-4-7-.03) to **force**
18 **consumers to bear 100% of the risk of cost increases** associated with
19 gas costs that are billed to consumers but never collected by the company.
20 Atmos argued successfully in that docket to transfer the risk of **cost**
21 **increases** to consumers. Atmos now claims to have produced **cost**
22 **decreases**, but does not want to assign 100% of the "risk" and 100% of the
23 supposed benefits to consumers. As shown in the example on **Attachment**
24 **A**, these "cost decreases" may not even be real. This certainly is not a
25 reasonable balancing of the risks and rewards of changes in management
26 and operating practices. Atmos wants no risks, just rewards.

1 **Q. Are there other problems with such a proposed change at this time?**

2 A. Yes. In light of recent events in the natural gas business, such as allegations
3 of price manipulation, erroneous price reports, and unreliability of "market
4 price" indicators, a detailed audit and review of the current facts should be
5 required to provide reasonable assurance that regulatory practices are
6 updated before any additional rate increases are charged to consumers.
7 Attachment B illustrates some of the current concerns through a recent
8 NASUCA resolution "Calling Upon State Regulatory Authorities to Participate
9 in the Investigations of False Reporting to Publishers of Natural Gas Price
10 Indices and Asking Federal Authorities to Provide State Authorities With
11 More Information on the Federal Investigations of False Reporting."

12

13 **Q. Do related party transactions present another layer of concern?**

14 A. Yes. Since AE is dealing with affiliate companies, the transactions should
15 be thoroughly examined for fairness and prudence.

16

17 **Q. How does the current tariff use transportation cost?**

18 The record clearly shows that AE is requesting a change in the PBRM as
19 governed by tariff sheet 45 of AE's tariff. Sheet 45.1 of the tariff states that
20 the PBRM "consists of two parts:

21 Gas Procurement Incentive Mechanism

22 Capacity Management Incentive Mechanism"

23

24 There is no issue with the TRA staff's audit findings on the Capacity
25 Management Incentive Mechanism portion of the PBRM. The only other
26 context for the discussion of transportation costs is the Gas Procurement

1 Incentive Mechanism portion of the PBRM.

2 Sheet 45.2, paragraph 1 states:

3 "For city gate purchases, these indexes will be adjusted for the
4 **avoided transportation costs that would have been paid if the**
5 **upstream capacity were purchased** versus the demand charges
6 actually paid to the supplier." [Emphasis added]

7
8 **Q. The existing tariff states that "For city gate purchases, these indexes**
9 **will be adjusted for the avoided transportation costs that would have**
10 **been paid if the upstream capacity were purchased versus the demand**
11 **charges actually paid to the supplier." What does this mean?**

12 **A** This clearly defines the appropriate adjustment necessary to exclude the
13 effects of transportation costs from consideration of the prices paid for
14 natural gas to make the indices comparable to purchases of natural gas at
15 the city gate. This adjustment is necessary to accurately compare an index
16 based on prices in Louisiana to purchases made in Tennessee. Since "city
17 gate purchases" would include all transportation costs necessary to bring the
18 gas from Louisiana to Tennessee, it is only fair to adjust the index price to
19 exclude the effects of the transportation costs that were avoided by buying
20 the gas after delivery.

21
22 It is clear that the intent of this adjustment for the "avoided transportation
23 costs" is to remove the transportation cost variable from the equation and
24 focus specifically on the cost of natural gas **excluding the effects of**
25 **transportation.** AE is now trying to redefine the incentive plan to **include a**
26 **new component for transportation costs.**

1 **Q. Would you explain why AE's approach to "savings" is inaccurate?**

2 A. AE's measurement of "savings" does not take into account the possible
3 effects of other cost increases that may be incurred to obtain those "savings."
4 For example, the LDC may game the PBR to reduce transportation costs,
5 but may increase the cost of gas, reservation fees, storage costs, or other
6 costs in the process. Since consumers are paying the increased costs,
7 those costs should certainly be accounted for in the measurement of
8 "savings." It is patently unfair for consumers to pay 100% of the costs of
9 certain expenses through the Purchased Gas Adjustment Mechanism while
10 the company keeps part of the "savings" gained from some other related
11 transactions. See **Attachment A** for an illustrative example of how a
12 reduction in transportation costs could actually cause the total cost of gas to
13 increase, thus rewarding Atmos for raising prices to consumers. This
14 example shows that using a "standard of performance" that is not based on
15 "market benchmarks" or "industry standards" will only reward Atmos for
16 buying gas so that rewards can be maximized without regard for the ultimate
17 cost to consumers. Atmos would be rewarded for buying gas at the Henry
18 Hub (Option 1) for \$5.50 delivered cost since it would get a \$0.25 bonus for
19 "TIF savings" even though gas could be purchased in Murfreesboro,
20 Tennessee at the same delivered cost of \$5.50. However, consumers would
21 have to pay Atmos a \$0.25 bonus for the "TIF savings" causing consumers
22 to pay \$5.75 instead of \$5.50. Atmos would be rewarded for a behavior that
23 would actually harm consumers.

24

25 In effect, the TIF formula is not a reasonable measure of performance or a
26 reasonable basis for incentives.

1 Q. Does AE propose to add a new category of bonuses to the PBRM for
2 "savings" in its filing in Docket No. 02-00850 without having an
3 accurate measure of savings?

4 A. Yes. After the TRA audit report revealed AE's violation of the existing
5 PBRM, on August 9, 2002, AE filed a proposed revision to tariff sheet 45 to
6 add a Transportation Index Factor Incentive Mechanism ("TIF") to the
7 existing PBRM. The next to last paragraph of the proposed revised tariff
8 Sheet 45.1 states: "The TIF establishes a predefined standard of
9 performance to which the Company's actual discounted transportation costs
10 from the discounted contracts are compared." [Emphasis added]

11
12 This "predefined standard of performance" is not "predefined" and it is
13 not a "standard of performance."

14
15 CAPD interrogatory item 9 in this docket asked Atmos to "List and describe
16 all credible market benchmarks or industry standards you are relying on in
17 formulating the proposed settlement and in claiming that the proposed
18 settlement is in the public interest." Atmos replied that "The Company is not
19 relying on any market benchmarks or industry standards in formulating
20 the proposed settlement or submitting the settlement for approval. The TIF
21 factor proposed by the petition in Docket No. 02-00850 utilizes the published
22 maximum FERC rate in its formula." [Emphasis added] Atmos admits that
23 the "predefined standard of performance" is nothing more than a "maximum
24 FERC rate" and is "not relying on any market benchmarks or industry
25 standards."
26

1 The failure to establish a "standard of performance" is a critical flaw in the
2 proposal. Since there is no established benchmark, standard of
3 performance, or "market" price for transportation services, "real" savings
4 cannot be accurately measured.

5
6 **Q. Is AE's proposal to change the rules and apply them retroactively**
7 **reasonable?**

8 **A.** No. The retroactive nature of the proposal is unreasonable and
9 unprecedented. What AE attempts to do is to change the rules of the
10 incentive plan and then to apply those rules as if they had been in effect
11 since April 1, 2001. Approving a change effective April 1, 2001 would clearly
12 violate established ratemaking principles that rates and rules are effective
13 until changed. The first paragraph of AE's tariff "T.R.A. No. 1, 2nd Revised
14 Sheet No. 45.1" which governs the Performance-Based Ratemaking
15 Mechanism states that "The PBRM will continue until it is either (a)
16 terminated at the end of a plan year by not less than 90 days notice by the
17 Company to the Authority or (b) modified, amended or terminated by the
18 Authority " There is no provision or precedent for modifying, amending or
19 terminating tariffs without notice and applying those changes retroactively.
20 Even when rates are set in error, the error has been corrected prospectively.
21 The Company has not terminated the PBRM "by not less than 90 days
22 notice." The Authority has not "modified, amended or terminated" the PBRM.
23 Therefore the current PBRM remains in force. Any change or termination
24 can only apply to future plan years.

25
26 AE's request to change the PBRM retroactively to April 1, 2001 would make

1 the change effective 16 months prior to AE's filing date (August 9th, 2002)
2 and **over three years** prior to the necessary approval of the TRA. To
3 approve rates based on a retroactive change in the PBRM would clearly
4 violate consumers rights to know the formulas used to establish rates.

5
6 **Q. Would the approval of AE's requested change to tariff Sheet No. 45**
7 **effective 4/1/01 be retroactive ratemaking?**

8 A. Yes. Setting rates or charges for consumers that are based on a change in
9 a tariff with an effective date prior to the date of the approval of the change
10 would constitute retroactive ratemaking.

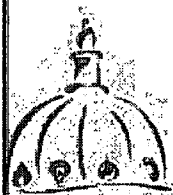
11
12 **Q. Does this conclude your pre-filed direct testimony?**

13 A. Yes.

14
15 ODMA\GRPWISE\sd05 IC01S01 JSB1 76869 1

Transportation Charges "Below Maximum FERC Rate" Does Not Mean Lower Total Cost To Consumers

Option 1				
Purchase point:				
Henry Hub				
	<u>Costs for</u>	<u>Proposed</u>	<u>Shared</u>	<u>Total Cost to</u>
	<u>Atmos</u>	<u>Standard of</u>	<u>Savings</u>	<u>Consumers</u>
Gas cost	\$ 5.00	\$ 5.00	\$ -	\$ 5.00
Transportation cost	\$ 0.50	\$ 1.00	\$ 0.25	\$ 0.75
Total delivered cost	\$ 5.50	\$ 6.00	\$ 0.25	\$ 5.75
Option 2				
Purchase point:				
Murfreesboro, TN				
	<u>Costs for</u>	<u>Standard of</u>	<u>Shared</u>	<u>Total Cost to</u>
	<u>Atmos</u>	<u>Performance</u>	<u>Savings</u>	<u>Consumers</u>
Gas cost	\$ 5.50	\$ 5.50	\$ -	\$ 5.50
Transportation cost	\$ -	\$ -	\$ -	\$ -
Total delivered cost	\$ 5.50	\$ 5.50	\$ -	\$ 5.50



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RESOLUTION

Calling Upon State Regulatory Authorities to Participate in the Investigations of False Reporting to Publishers of Natural Gas Price Indices and Asking Federal Authorities to Provide State Authorities With More Information on the Federal Investigations of False Reporting

WHEREAS, Published natural gas price indices are widely used in Local Distribution Company (LDC) tariffs for the calculation of balancing cash-outs and penalties,

WHEREAS, Published gas price indices are also widely used in purchased gas cost adjustment and performance based ratemaking proceedings for LDC's,

WHEREAS, Published gas price indices are extensively used in LDC contracts with natural gas suppliers,

WHEREAS, Widespread use of published natural gas price indices in gas contracts and in state regulatory proceedings makes it imperative that the indices are accurate and are not subject to manipulation,

WHEREAS, The Commodities Futures Trading Commission (CFTC) and the FERC have instigated investigations and engaged in enforcement actions concerning problems with published price indices and instances in which companies have provided false data to publishers of the price indices,

WHEREAS, Neither the CFTC nor the FERC has revealed the geographic hubs affected by the false reporting,

WHEREAS, Disclosure of the geographic hubs involved in the CFTC and FERC investigations and enforcement actions will provide state regulatory authorities and other natural gas market participants with valuable information regarding the scope of the impact of the false data reporting,

WHEREAS, In Resolution Number 2003-1, NASUCA urged the FERC to investigate the accuracy of published price indices and potential remedies to ensure accurate price indices,

WHEREAS, Any regulatory response taken by the FERC could have a significant impact upon the gas purchase contracts of LDC's and the ratemaking procedures used by state regulatory authorities,

WHEREAS, State regulatory authorities can assist the efforts of Federal regulatory authorities by making efforts to determine whether entities subject to state jurisdiction are involved in false reporting of gas prices,

THEREFORE BE IT RESOLVED, that NASUCA encourages state regulatory authorities and LDC's to monitor the FERC's investigation of the natural gas price indices, standards and auditing procedures and to participate in the FERC's development of potential responses to ensure the accuracy of price indices,

BE IT FURTHER RESOLVED, that NASUCA encourages the CFTC and the FERC to provide more information to State Commissions, Consumer Advocate Offices and other appropriate state and federal agencies regarding the geographic hubs involved in their investigations and enforcement actions of companies engaged in false reporting of natural gas prices,

BE IT FURTHER RESOLVED, that NASUCA calls upon state regulatory authorities to make efforts to determine whether entities subject to their jurisdiction are engaged in false reporting of gas prices,

BE IT FURTHER RESOLVED, that NASUCA calls upon state regulatory authorities to establish protocols for referral of suspected false reporting to appropriate state or federal authorities if entities subject to state regulatory jurisdiction are found to have engaged in false reporting of natural gas prices,

BE IT FURTHER RESOLVED, that NASUCA encourages state regulatory authorities to make efforts to determine whether entities subject to their jurisdiction are taking prudent measures to assure that any indices they rely on in natural gas supply contracts are accurate.

BE IT FURTHER RESOLVED, that NASUCA authorizes the Executive Committee to develop positions and take further actions consistent with the contents of this resolution. The Executive Committee shall inform the membership of such positions and actions prior to proceeding with them, if at all possible. In any event, the Executive Committee will advise the membership of any actions taken consistent with the recommendations contained herein.

**Approved by NASUCA:
March 6, 2003**

**Submitted by:
NASUCA Gas Committee**

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